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ABSTRACT

As a part of a study on financing higher education in California, information is presented on student loans and alternative methods of financing. Part 1 reviews problems caused by a heavy reliance on the federal Guaranteed Student Loan program (GSL). It discusses troubles of the GSL program; the lack of policy purpose; program costs; defaults; generic problems of student loans; and defining the role of loans. Part 2 deals with financing alternatives for higher education, comparatively analyzing proposed new ways of financing higher education that might reduce the dependence on the GSL program. It focuses on the shared burden of financing higher education; the sources of strain on parents and students; managing burdens through managing risk; incentives for financial planning to manage burdens; the importance of details; income contingent loans; prepaid tuition; college savings bonds and IRAs; public service benefit programs; and such additional alternatives as cooperative education programs, raising student earnings expectations, and parental loans tied to the need analysis system. The importance of not repeating the mistakes of the GSL program when new financing mechanisms are introduced is stressed. Lessons drawn from the GSL experience include the following: over-reliance on one financing mechanism risks distorting educational decisions and shifting the burden of cost to one party; subsidies can lead to such over-reliance and can crowd out appropriate growth in grant programs; and great harm to the effectiveness of the student financial aid system can result. Contains 16 references. Tables are included. (SM)

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A Review of Student Financial Aid in California

Paying for College:

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Mechanisms*

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PREFACE

Student financial aid has become a major and complex educational industry. This year in California alone expenditures will be approximately \$1.5 billion in all forms of financial assistance—grants, loans, and jobs. It is not only large, it is also complex. Anyone who has been associated with student financial aid is soon struck by how complicated the rules and structure are and how the students and colleges must deal with a multitude of agencies and organizations.

Thirty years ago student financial aid in California was less than \$10 million. The few government programs that existed were relatively simple in design. While funds were inadequate, the standards and procedures were comprehensible to all involved. Administration was, by today's standards, simple. Limited student financial aid, largely scholarships, was an activity funded by individuals, college endowments, and local groups. Even scholarships financed by PTA bake sales or similar activities were important to the total structure of financial aid.

Over the last three decades all financial aid has grown and its composition and sources of funding have markedly changed. In the last ten years loans have replaced grants and scholarships as the principal form of student aid. With a massive infusion of loan funds through commercial lenders, the nature of student financial aid has changed.

As student financial aid has assumed a larger role in postsecondary education, it has become more

important to review the policies that have undergirded it. Policies, either as specifically adopted or developed in an evolutionary way, need to be reviewed for their past effect, current value, and future utility. Problem policies need to be identified and policies appropriate for the balance of this century developed.

Concerns about student aid policies led to the creation of The Eureka Project, a privately organized, funded, and directed review of student aid policies in California. It is entirely funded by major grants from the James G. Irvine, Weingart, and John Randolph Haynes and Dora Haynes foundations, and by a supplemental grant from the Atlantic Richfield Foundation.

The Eureka Project is under the general direction of a board of directors, with more technical and specific advice to the project given by a steering committee composed of representatives of interested groups and institutions in California. A staff of consultants has come together to direct and write the various studies under The Eureka Project.

The Eureka Project is studying the financing of higher education opportunities in California and the impact of current financial aid programs upon the formal structure of higher education and students. There is concern that the door of educational opportunity may be closing, that the health and vitality of quality independent institutions could be at risk, and that the current student financial aid system has a wide range of unintended consequences.

The Eureka Project anticipates issuing approximately a dozen reports. These reports will endeavor to stimulate policy review of student financial aid and financing of higher education in California and will be offered by the Board of Directors as thoughtful documents for that purpose. The reports will not necessarily represent the views of members of the Board of Directors or of the four California foundations whose grants have made The Eureka Project possible.

This particular report is largely the work of Martin Kramer, former Deputy Assistant Secretary of Health, Education and Welfare in the federal

government and Senior Fellow for the Carnegie Council on Higher Education.

A number of individuals have contributed to this report by reading earlier versions and making suggestions for its improvement. We are especially grateful to Marge Dickinson of the University of California at Davis, Janet Hansen of the College Board, Arthur Hauptman, Robert Huff of Stanford University, and William Van Dusen.

It is hoped that the studies from The Eureka Project will be useful references for individuals who will be deciding the future of student financial aid in California.

Arthur S. Marmaduke
Executive Director
The Eureka Project

EXECUTIVE SUMMARY

The report falls into two parts. Part One is a review of the problems that have come about because of heavy reliance on the federal Guaranteed Student Loan program (GSL). Part Two is a comparative analysis of proposed new ways of financing higher education that might reduce dependence on the GSL program.

A theme of both parts of the report is the importance of not repeating the mistakes of the GSL program when new financing mechanisms are introduced. The report draws these lessons from the GSL experience:

- (1) Over-reliance on any one financing mechanism runs the risks of distorting educational decisions and shifting too much of the burden of higher education costs to one party—whether it is parents, students, institutions or the public.
- (2) Subsidies can lead to such over-reliance and can, if not kept under control, crowd out appropriate growth in grant programs.
- (3) Unless great care is given in advance to identifying possible unintended effects of proposed program mechanisms, great harm to the effectiveness of the student financial aid system and its long-term public support can result.

The major problems specific to the GSL program have been:

- (1) Its lack of a defined (and limited) policy purpose in a balanced system of targeted programs;

- (2) Excessive subsidies which have driven up program costs and produced rapid growth without policy direction; and
- (3) High default rates resulting from reliance on GSL loans by students for whom other kinds of financial support would be more appropriate.

There are also generic problems of student loans, when relied upon in the absence of adequate amounts of more appropriate aid. Placed in this situation, students may either narrow their educational options with a view to being able to repay loans more easily, or they may reduce their educational participation in order to avoid borrowing. Either way, education itself can suffer.

In order to end over-reliance on the GSL program, new financing mechanisms will be needed. Each proposed mechanism usually would tap the resources of one of the parties to higher education finance: parents, students themselves, institutions or the public. A new mechanism may increase the burden of one party if it, in turn, is overly depended upon. New mechanisms do, however, offer the prospect of making the financial burdens of the parties easier to manage.

Four main types of financing proposals are being widely discussed and are examined in the report:

- (1) *Income-contingent loan plans* that would make the amount of repayments on student loans depend on the income of the borrower.

Repayments would be greater when income is greater, smaller when smaller, so that the borrower would never have to face paying a large percentage of income.

- (2) *Prepaid tuition plans* that would permit parents (and others) to pay for tuition expenses incurred in some future year at today's prices. The purchaser would forego an ordinary investment return on the amount paid, and instead would have the peace of mind of passing on to others the risk of future tuition increases.
- (3) *Tax-free or tax-deferred savings plans* that would give parents (and others) a tax benefit as an incentive to save for college expenses. In a tax-free plan there would be no income tax payable if accumulated principal and interest is ultimately used for education. In a tax-deferred plan, tax would be payable only at time of withdrawal, as with IRAs.
- (4) *Public service plans* that would create opportunities for students to work in public service jobs and thereby accumulate credits against educational expenses.

All four types of proposal would give parents and students new incentives, financial or otherwise, to plan how they will meet their shares of college costs. Having a workable plan itself serves to alleviate financial strain, because it permits more farsighted decisions about how much of college expenses should be met out of saving in advance of college, how much out of current earnings while the student is in college, and how much out of later earnings—through repaying loans.

In other respects, however, the four kinds of proposal differ greatly. Prepaid tuition and income-contingent loan plans emphasize ways of dealing with risks—respectively, the risk of tuition charges rising more rapidly than parental income and the risk of after-college income too low to make conventional loan repayments manageable. The opportunity to manage risk is the main incentive for people to participate in such plans. Subsidies could provide additional but perhaps unnecessary incentives.

Subsidies are a more integral feature of savings

programs with tax benefits. Families, of course, have good reason to save for college even without tax benefits, but proposals to confer such benefits are based on the premise that additional incentives are needed if we want more families to save and more habitually.

In public service plans the premise for providing subsidies or subventions is that enough public service jobs for students will not be available otherwise. Funds are needed so that employers will be willing and able to hire students or prospective students and so that students can see such service as a realistic way to further their educational aspirations.

It is crucial for plans of all four types to achieve leverage in any use they make of subsidies. That is, they should aim at an increase in the total resources available for financing higher education, net of savings and earnings that would be available anyway. Ideally, the increase should be in an amount large enough so that some of the student aid resources plan participants would otherwise receive can be reallocated to grant programs targeted on students from low income families. Otherwise, the new plans would tend to continue the situation in which GSL subsidies have crowded out appropriate funding increases in grant programs.

In plans of all four types details are extremely important. This is true of subsidy entitlements, but it is also true of many other plan features. Many prepaid tuition plans and income-contingent loan plans are framed in terms of difficult predictions about the future. If the predictions are only slightly wrong, the participants or the plan sponsor may be seriously disappointed. Large scale public service employment plans are also vulnerable to poor choices about program details. They could encounter very serious administrative difficulties as a result. Least vulnerable to decisions about details are college savings bonds and college savings accounts. Their operation is easily understood by participants and their results are relatively predictable.

Any plan should help to minimize parent and student anxiety and encourage long range financial planning and educational aspirations.

FOREWORD

This report consists of two parts. The first is a review of the reasons why the new dependence on student loans for the financing of higher education has come to seem so troubling to many observers. The second part is a summary of options available for reducing that dependence.

The two parts are obviously related—a discussion of the problem followed by a discussion of possible solutions. But they are related in a deeper way as well. Part of the problem of student loans is that their much wider use has shifted a substantial part of the burden of financing higher education from parents and the public to students themselves, and without any explicit or thoroughly discussed change in public policy. The search for alternatives to student loans should not repeat this mistake. It should be attended by a conscious focus on the issue of who *should* bear the burdens of financing post-secondary education, and in what proportions. The intriguing features of some of the proposed alternatives should not be allowed to distract attention from that overriding issue.

Another link between Parts 1 and 2 of this report is that both the Guaranteed Student Loan (GSL) program and the alternatives to it involve several different parties. Financial institutions, families, colleges and state and federal government agencies have all been involved in the GSL program. Each party has incentives and disincentives to play its desired roles but often the disincentives have proved stronger, caus-

ing the parties not to play the roles Congress intended for them. In these cases, very complex laws and regulations have been adopted in an attempt to *compel* the desired behaviors. They have frequently not worked. As a result, the program often appears not administerable without levels of fraud and abuse that are unacceptable to the public and that give student financial aid in general a bad name.

There is some sad experience here that should not be lost to view when other kinds of multi-party programs are designed, however intriguing their mechanisms. Incentives should exist (or be created) for every party to perform its functions responsibly and in keeping with program objectives. If a program cannot be simple and self-policing it probably should not be adopted at all.

There is a third connection between Parts 1 and 2. The GSL program has become enormous—and an enormous problem—because of heavy subsidies. There can be little question but that these subsidies have tended to crowd out funding for grants. And, while credit and jobs can be created without predetermined limits by the economy, grants can *only* be funded with subsidy dollars. Subsidy dollars come from taxpayers and from philanthropy and are inherently scarce and rationed. Accordingly, it has to be one of the lessons of the GSL experience that new programs should be scrutinized closely to decide whether they really need to be subsidized in order to work and whether they would distribute

subsidies as fairly as grant programs.

There are thus a number of lessons in the GSL experience that the federal government would do well to ponder as alternatives for financing college are considered. They are lessons also for California if, as we suspect, much of the leadership and innova-

tion in student financial assistance will have to come from the states. There are questions about most of the frequently discussed alternative financing mechanisms that need to be examined in patient detail if some unfortunate history is not to repeat itself.

1. THE PROBLEM OF STUDENT LOANS

Student loans can solve some problems of higher education finance, but they can also create problems. They can provide a vehicle for the student to take serious responsibility for part of the costs of education. They can make it possible for the student to choose a distant or higher cost college, when that choice would not be supported by other elements of the student financial aid system. They can be useful to independent and graduate students who can expect little or no contribution from their families. The availability of loans, whether or not used, can provide the assurance of a reserve line of credit available to make up for shortfalls in other resources relied on in the student's initial financial plan—less money from home, or less earnings or less grant aid than had been counted on.

It is when loans are depended upon as a large and basic part of the financial plan of many students that loans create as well as solve problems. This is what has happened over the last ten years. The reason for this development is the very rapid growth, both absolute and relative, of a single federal program, the Guaranteed Student Loan program (GSL). In 1975-76 GSL loans totaling \$1.3 billion were made under the program nationally, and \$62 million in California. Ten years later, in 1985-86, \$8.8 billion was lent nationally and \$656 million in California. In 1975-76, GSL loans comprised 12.1 percent of all aid nationally and 12.3 percent in California. In 1985-86 the percentages were 42.0 nationally and

42.2 in California. Just between academic years 1982-83 and 1985-86 the *number* of loans increased 30 percent at the University of California, 23 percent at California State University, and 12 percent at independent institutions. At California community colleges the number declined by 3 percent, but it increased an enormous 53 percent at California proprietary schools.*

Without some of this growth the financing of higher education would have been a very difficult, if not impossible undertaking over the last decade. As aggregate levels of grant funding declined in relation to costs of attendance, GSL loans were available to fill the widening gap. It is hard to see how higher education, particularly independent higher education, could have survived the decade without them.

Nevertheless, the growth of the GSL program is troublesome for a variety of reasons. It is important to distinguish two sets of them. First, there are the problems created by the GSL program itself—its statutory mechanisms, the terms of the loans made under it and the administration of the system. Second, and quite distinct, are the problems created for the financing of higher education by over-reliance on student borrowing in general. This second group

*The national figures cited are from the College Board series, *Trends in Student Aid*. The California figures are from the California Student Aid Commission.

of problems would need to be addressed even if the problems specific to the GSL program were solved. Depending on debt financing of any sort creates problems; debt financing within the GSL framework has created *additional* problems.

The Troubles of the GSL Program

A list of the problems specific to the GSL program could be a very long one. The program has been a battleground, and each advance and retreat of the legislative and regulatory armies has left its share of boot prints. Some of the problems are minor irritants to the students, state agencies, lenders and colleges concerned, and these problems only cumulatively constitute an obstacle to having an efficient and successful program. But other problems are major, and go to the nature of the program and its way of functioning. These latter are the ones that will be discussed here.

The Lack of Policy Purpose

The greatest single problem of the GSL program is that it simply has no clearly defined purpose or mission. It provides credit to meet the costs of all kinds of students, possessing all degrees of credit worthiness and enrolled in all kinds of postsecondary educational programs. With few exceptions, all students receive loans on the same terms—the chief exception being that upper classmen and graduate students may borrow more than freshmen. Otherwise, all borrowers are pretty much in the same boat. For example, students ordinarily have had the same ten-year period to repay their loans whether they have borrowed little or a great deal, whether they are on a path to a career with high earnings prospects or one with poor prospects. There are ways for some student borrowers to tailor repayment terms somewhat to their special situations, but a ten-year repayment period is what almost all kinds of borrowers are allowed. Consolidation of loans with longer repayment periods is to be made available under the 1986 Higher Education Amendments, but no one can be sure how well it will work and for how many students.

The reason why the GSL program has become

all things to all students is that it was framed initially as a vehicle for loans of convenience to middle income families that could be expected to take a traditional middle-class responsibility for educational expenses, but could do so more manageably if given several years to pay. For such families no precise tailoring to the circumstances of a particular category of students seemed necessary. Nor did it seem necessary to give such loans a defined place in the overall system of higher education finance.

Over the years, however, other students in other situations have been added to the convenience borrowers: students attending high cost colleges, students whose parents refuse to pay, trade school students, students whose parents simply wanted a low interest loan in a period of high inflation and now, students who must borrow simply because enough aid in other programs is not available. And with the 1986 Amendments, the convenience borrowers are actually to be excluded from GSL benefits, although the structure of the program makes most sense for them.

Over this history some roles for student loans have emerged that seem good ones. Loans can allow a degree of responsibility, choice and security to decisions about college. If these were the defined and limited purposes of student loans, some of the features of the GSL program that are now so troublesome would be much less so. But the program would also be much smaller and not relied upon by many of the borrowers who do so today. Definition of the policy purpose of student loans and their role in the overall system of higher education finance is thus, at many points, a necessary step in coming to grips with features of the GSL program that cause trouble.

Program Costs

A second problem of the GSL program is cost. In 1975-76 the program required federal appropriations of \$808 million. In 1985-86 these costs had risen to \$3.3 billion.* These costs are not the result of providing capital to be lent to students, but mainly (a) costs of subsidizing interest rates so that borrowers will not have to pay market-derived interest rates and (b) costs of paying lenders to make good on defaulted loans. Taxpayers have good grounds for complaint about these costs, and such complaints, together with

*The figures are taken from the College Board series, *Trends in Student Aid*.

pressure from the federal budget deficit, have lately brought about attempts to rein in costs. But they remain massive.

The worst thing about GSL costs, from the point of view of the effectiveness of the student financial aid system, is that appropriations for student loan accounts in the federal budget tend to crowd out appropriations for other student aid programs that would reduce the heavy reliance on borrowing. A right to a stream of subsidies, extending over many years, is created every time a loan is guaranteed under the program. An eligible student has a right to such a guarantee if he or she can find a willing lender. The subsidies have made lenders very willing. Entitlements to subsidies continue to pile up years after loans are made, years, even, after the borrowers may have graduated. Under now chronic federal budget constraints, GSL subsidies to students who graduated from college five years ago, and may never have really needed a loan at all, are almost certainly depriving low income students starting college today of the grant assistance they need.

The other side of this relationship is what has made the GSL program attractive in political terms. Because loan costs can be shoved forward into periods for which budget dollars are not yet being fought over intensely, eligibility for the subsidies has been hard to combat. Moreover, ending the competition between GSL and other programs is thereby made very costly in the short run. It would be hard to fund the subsidy commitments inherited from past excesses and also *at the same time* to fund programs that would make it less necessary for present students to borrow.

The subsidies in the GSL program are of several kinds. It is important to distinguish among them because the merits of some—or at least the relative harmlessness of some—are used in defense of the entire system. Four kinds of subsidy are involved:

- (1) The difference between the higher rate of interest on an entirely private loan and the lower rate on one effectively guaranteed both as to principal and interest by the federal government represents a major subsidy.* Such subsidies have ripple effects in credit markets generally, and they tend to escape the discipline of the federal budget process. They would,

however, be defensible in a program that sought to allow all students to use modest amounts of credit for policy-defined purposes, without distinction of credit-worthiness.

- (2) The “in school” subsidy that pays lenders the amount of interest on a loan up to one of several ceilings imposed by law, ordinarily until borrowers have ceased to be students.
- (3) Additional percentage points of interest above the applicable ceiling rate, called “special allowances.” It is necessary to pay lenders these allowances, both during and after periods of enrollment, in order to bring the total yield of student loans up to a level that will make them reasonably attractive uses of lenders’ money in the light of lenders’ costs and their alternative investment opportunities. If these subsidies were small enough, they would have the merit of allowing students predictable interest rates and lenders predictable returns.
- (4) The portion of the “special allowances” that exceeds the amount necessary to make student loans a competitive investment. This portion makes student loans *more* profitable to lenders than alternative loans. This is not a separately authorized subsidy, but it is useful to itemize it separately because it is different from the other three: *they* benefit students; *this one* benefits lenders.

There is no question that these subsidies accomplish their avowed purposes. The trouble, besides their cost, lies in the incentives they create: Subsidies (1) through (3) create a situation in which the more the student borrows, the more subsidy he or she receives. At the same time, subsidy (4) creates a situation in which the more lenders lend the more subsidies *they* get. In the late 1970’s these incentives constituted a very powerful engine for program growth—growth that built such high subsidy costs into the federal student aid budget that much less leeway was available to allow for growth in grant programs to keep up with inflation.

Subsidies (2) and (3) were somewhat reduced in the Higher Education Amendments of 1986, effectively reducing (4) also. The amount of a student’s eligibility to borrow was limited to the amount of demonstrated financial need measured, approximately, according to the traditional methods of need analysis. There will clearly be new brakes on the engine.

*This guarantee may be lost by a lender if irregularities surface in default proceedings, and some part of the subsidy under item (4) below may, in fact, compensate for this risk.

Whether they will slow growth enough to allow the funding of grant programs to catch up is, however, uncertain. Higher loan limits for juniors, seniors and graduate students may work powerfully the other way.

Defaults

The problem in the GSL program that has outraged the public is none of the foregoing, but that of students who do not repay their loans—that is, who default. Although most students have taken their responsibilities seriously and have made sustained efforts to repay, some have been careless or defiant, and sometimes this group has included as many as half of the borrowers at a particular institution. Over much of the history of the GSL program California has had among the highest default rates of any state, and the penalties for high default rates that Congress has enacted are likely to be felt with special force in California.

What is known about the default problem exonerates no one. The structure of the program is itself implicated. To get lenders to make loans to all, the program makes lending virtually risk free. There can then be little incentive for lenders to be enterprising in getting students to repay. State agencies have been given administrative responsibility, but little latitude to improve the way the program works and none to decide what students and institutions should be eligible.

The borrowers most likely to default are students who fail to complete their programs and find, naturally enough, that their participation in postsecondary education has in no discernible way increased their earning capacity. They would like unilaterally to write off a poor investment that, many of them probably believe, they were misled by others into making. Certainly they are often led to regard enrollment and borrowing as components of an attractive package. It is not in the interests of either recruiting institutions or lenders to urge special caution or to withhold loans in the case of students whose prospects of course completion and loan repayment are bleak.

The foregoing problems of the GSL program could be solved, or at least much reduced. Limits on eligibility could exclude the most default-prone borrowers. Longer or more flexible repayment terms

could make the loans easier to repay and would also reduce defaults. Incentives both to lend and to borrow could be reduced. Lenders and aid administrators could be put in a position where incentives would be more balanced and where they would be more willing to “just say no” to students who they believe would be ill advised to borrow. Students could be given incentives to get in the habit of paying loan installments promptly. There are doubtless members of Congress who would say that the 1986 Amendments represent significant progress on some of these points, and perhaps they do. For example, the amendments provide for an increase in the interest rate charged borrowers (from 8% to 10%) in the fifth and subsequent years of repayment.

Generic Problems of Student Loans

The trouble is that even a great deal of progress on the specific problems of the GSL program would still leave the generic problems of student loans untouched. When a student relies heavily on borrowing to finance education, the student is plunged—it may be a cold plunge—into the world of fine-tuned investment calculations. How much future cash flow will be committed to debt service? Will the investment produce more or less cash flow than required to repay the loan? There is no question but that some students are up to this kind of calculation. One would be disappointed, certainly, if most MBA candidates were not. But can one really believe that a “high risk” community college or trade school student is likely to be up to it, or a freshman in a liberal arts college for that matter? Instead of a kind of calculation that economists have declared would be beneficial to the market for human capital, there is likely to be no calculation at all, or a calculation so flawed by wrong facts, hopeful or pessimistic assumptions and the anxieties of growing up that what occurs is a parody of astute decision-making.

Some educators believe they are seeing such parodies. The returns from a liberal arts education seem grossly discounted by many students. There seem to be successive stampedes now to one career specialty, now to another. Students in droves seem to commit their GSL entitlements to proprietary school programs on the simple premise that, since some people make a lot of money in a given trade, they will also. On the other hand, some students,

even among those with good to excellent prospects, are so fearful of loans that they sacrifice extracurricular participation at their colleges in order to earn enough currently to minimize borrowing or avoid it altogether.

These are results that are only to be expected from a massive shift to credit financing of higher education. But this is not quite all. Debt financing grew rapidly in the late 1970's to take the place of proportional growth in contributions by parents and grants from public sources. Students must, therefore, be only too aware of what loans are *not*. They represent the *withholding* of an investment in the student by others, and this must be perceived as a *de facto* qualification to the commitments of parents and society to the values and opportunities of higher education.

Surely it would be safer in terms of these values and opportunities to designate an appropriate, limited role for student loans in the financing of higher education in relation to other sources of support. This is no mere academic issue. Indeed, the issue arises immediately in intensely practical terms as soon as reforms to the GSL program are considered that go a little way beyond those of the 1986 Amendments.

If loan amounts are to be limited to what borrowers can be expected to repay without hardship, where is the rest of the money going to come from to enable students to pay their college bills and to enable colleges and universities to pay *their* bills? If high risk students are to be excluded from the program, are they then to be denied educational opportunity, or are other sources of funding going to be found for them? If students and their families are no longer presented with incentives that make borrowing excessively attractive, what alternatives are they going to have in terms of opportunities to earn and save the money they need?

Defining the Role of Loans

The only kind of answer to these questions that can really count as an answer is one that defines the

role of loans relative to the other forms of student aid and to the other sources of higher education finance. If the role of student loans should be smaller, both for the individual student and in the larger scheme of higher education finance, what *other* roles should be larger? If the student generation should bear a smaller portion of the burden through borrowing against future incomes, how much should they instead be expected to earn in the present? How much should the current generation of parents bear? The current generation of taxpayers? If loans are a poor (or very limited) method of providing educational opportunity to the disadvantaged, how much and what kinds of other aid should be offered them? Tinkering with the rules of the GSL program cannot get very far without encountering these apparently theoretical, but intensely practical questions.

Because these questions really are practical, a second set of questions lurks not far behind them. By just what means will all the parties to higher education finance be able to perform their roles? Can burdens, fair or not, be made easier to bear? What choices can the parties be offered for bearing them? What back-up resources should be in the system when the usual mechanisms fail?

The second part of this report looks at some of these questions about alternatives to student loans for financing higher education. To consider these alternatives does not prejudge fundamental issues about the role of student loans. Nor does it presuppose a decision to replace the GSL program altogether. A reformed and reconstituted GSL program may well fill an important role far into the future. Nevertheless, there is wide agreement that at least some things are now seriously wrong with the extent and depth of reliance on the GSL program. It is not practical to reduce this reliance without thinking through the redistribution of financial burdens that would result and the fairness and convenience of the mechanisms that would be involved in sustaining them. After all, the vast growth of student borrowing has come about because money really is scarce, and painful to extract from students, parents, taxpayers and institutions alike.

2. FINANCING ALTERNATIVES FOR HIGHER EDUCATION

A widespread sense of urgency about finding new ways to finance college education springs from a number of perceptions:

- Governments, both state and federal, seem reluctant to pay a larger share of costs—not enough larger, anyway, to take growing financial burdens from the shoulders of parents and students.
- Institutions are thought likely to increase tuition charges in the future at a rate faster than the rate of inflation, as independent colleges have been doing in the 1980's. Institutions appear now less able than in the 1970's to hold down tuition by not recovering costs for facilities, by sacrificing faculty salaries, and by foregoing opportunities for quality improvement.
- Finding more and more aid funds for needy students in the institution's own budget has entailed higher and higher tuition levels for full-price students at independent institutions. Colleges and universities are concerned about reliance on this "Robin Hood" practice—about how far it can and should go.
- Even if student debt burdens are not already too high, they cannot be increased indefinitely to make up for short-falls in financing from other sources.

The high level of concern about finding new ways of financing higher education expenses is a fairly recent development. In the 1970's federal and state

funding for student aid was growing (other than for veterans). Interest subsidies on Guaranteed Student Loans (GSL), in combination with inflation, greatly reduced the real burden of borrowing. Colleges were reluctant to increase tuition faster than inflation, and usually increased it less. All of these conditions—inherently unstable as they were—have now changed. The search for additional, or alternative financing mechanisms has accordingly moved higher on the agenda of higher education policymakers.

The Shared Burden of Financing Higher Education

Accepting the urgency of the problem does not, however, prejudice the appropriateness of the present size of the financial burden borne by each of the parties to higher education finance—parents, the public, students themselves and institutions. To get our bearings among the competing proposals for financial alternatives it is worth asking whether the financial strain each of the parties is experiencing arises because its present share of the financial burden has grown too large, or whether it is because its burden, although growing only proportionately with its resources, is simply too awkward to manage. If too large, then this could argue in favor of mechanisms that would tend to shift burdens somewhat to other

parties. If the burden is troublesome because it is awkward to manage, then this would argue for better or more varied ways of handling the burden.

The Sources of Strain on Parents

Looking at financial burdens in this way could, in principle, be undertaken with respect to any of the financing parties, but it is obviously critical with respect to parents. One relevant point is fairly clear: For typical parents who actually pay all or a given portion of the college costs of their children, the financial burden has *not* become notably heavier over the last two decades. A number of studies made in the late 1970's, in connection with controversy surrounding the Middle Income Student Assistance Act, failed to find any convincing evidence that the costs of higher education had become more than modestly more burdensome in the preceding decade, and the same can be said now, at least in the case of students attending public institutions. Chart 1 shows a number of comparisons of median family income and costs of attendance, both nationally and for California. Only in the case of independent colleges and universities have costs increased substantially as a percentage of median family income. To pay the costs of an independent four-year college would appear, nationally, to have involved the sacrifice of an additional 6.8 percent of median family income in 1985 over the amount for 1977. In California the increase would appear to have amounted to 5.6 percent for all independent colleges and universities.

Some cautionary notes are in order, before discussing what one really should make of these figures. First, there are persuasive arguments for using other measures of income change rather than median incomes. Unfortunately, however, there are no data to permit adjustments relevant to the issue at hand, that is, adjustments specifically for parents of college-age children in California. Second, while the national and state cost figures have been made as comparable as possible, this has entailed limiting the kinds of costs included to tuition, fees, room and board, even though there are other real college expenses. To make the figures more comparable *among* California institutions the standard amounts allowed by the California Student Aid Commission for off-campus room and board have been used, rather than the averages used by the College Board in developing the na-

tional figures. A further complication is that only *some* of the California independent institutions are four-year colleges; others are universities. So comparisons over time are most appropriate, not comparisons between state and national institutional categories.

Most of the cost increases *look* as though they are in the range of normal family belt-tightening, except perhaps the independent college costs. The problem with this impression is that we do not know how tight the belt already was in 1977, and how other factors may have been making it tighter even as college costs, relative to incomes, rose modestly. These latter factors may include:

- (1) Increases in other family budget items, such as housing costs.
- (2) Diversion of some family financial capacity to new budget items.
- (3) The loss of eligibility for GSL loans and Pell grants on the part of many middle income families.

The third point bears special emphasis. For budgetary reasons, the category of those eligible for the full benefits of the GSL program has been reduced, in stages, until, with the 1986 Higher Education Amendments, the GSL program has lost altogether its role of meeting the convenience requirements of parents. The reduction of the category of eligibles has occurred without a corresponding expansion of alternative mechanisms to meet those requirements. The PLUS program (CLAS in California) has as yet taken up only a small part of the slack.

But there is no apparent reason to think that the loss of GSL subsidies themselves is the cause of strain on parents, rather than the loss of convenience provided by the program. There is more probably a need to make parental financial burdens more manageable than a need to shift a larger portion of them to other parties. That is, except in the case of parents of students attending independent institutions, where some shifting may be called for if traditional relationships are to be restored.

The Sources of Strain on Students

What has been said here about parental burdens in the case of dependent students probably applies, with modest qualification, to independent students

CHART 1
College Costs and Family Incomes
1977 and 1985

	Median Family Income	College Costs	Costs as Percent of Income
United States			
1977	\$16,009	Public University:	\$2,167 13.5%
		Public Four-Year College:	\$1,924 12.0%
		Independent University:	\$5,193 32.4%
		Independent Four-Year College:	\$3,811 23.8%
1985	27,735	Public University:	\$4,170 15.0%
		Public Four-Year College:	\$3,750 13.5%
		Independent University:	\$11,110 40.1%
		Independent Four-Year College:	\$8,500 30.6%
California			
1977	16,960	UC:	\$3,835 22.6%
		CSU:	\$3,319 19.6%
		Independent Colleges and Universities:	\$6,584 38.8%
1985	30,837	UC:	\$7,306 23.7%
		CSU:	\$6,607 21.4%
		Independent Colleges and Universities:	\$13,690 44.4%

Note: Dollars are current dollars. Costs are for the academic year beginning in the income years. California costs are tuition and fees plus standard CSAC off-campus costs for room and board. Independent college tuition and fees are the averages paid by Cal Grant A recipients attending such colleges. Data sources and assumptions for the U.S. calculations are explained in The College Board publication *Trends in Student Aid*, 1983.

Sources: California Student Aid Commission, The College Board, U.S. Bureau of the Census, *Current Population Reports*, Series P-60.

also. The 1985 burden of meeting college expenses for an independent student was, relative to income, probably somewhat heavier than for a member of a household with the same number of full-time equivalent wage earners in 1975. It was probably somewhat heavier, because an increase in the number of wage earners per household accounts for part of the growth in median family income. If so, cost burdens must have become considerably more troublesome for *young* independent students, who have had little time to accumulate savings and must meet any given level of costs out of current earnings or loans to the extent costs are not offset by grants.

However, the important changes for students, both dependent *and* independent, are those that have occurred within the aid system, not in ratios of college costs to incomes. In the late 1970's and early 1980's the portion of financial need covered by grants declined in a very serious way. For example, the federal Pell and state grants of the average Cal Grant student together covered 66.3 percent of measured financial need in 1979-80. In 1986-87 they covered 44.5 percent. This trend has meant much greater de-

pendence on borrowing, and for students, the changes in GSL subsidies *are* important. There were some GSL borrowers in the late 1970's for whom the combined effect of the subsidies and general inflation was to cut the constant-dollar amount of their debt in half before they had even graduated or repaid a penny. For many borrowers, the benefits were almost as great. The decline in inflation together with the trimming of the subsidies has changed this situation dramatically. And soon GSL interest charges will no longer be tax deductible. Students will be paying back in constant dollars most of what they borrow in constant dollars, if projections of moderate inflation are borne out. And a difference of, say, \$500 a year in real repayment burden tends to be a much larger percentage of a young person's earnings than of his or her parents'.

A plausible assessment of the changed burdens of students can be phrased in terms of traditional need analysis concepts for discussing the student's obligation of self help in meeting his or her financial need. Traditionally, what students are expected to contribute as self-help can either be current

earnings from school year and summer jobs or future earnings, the after-graduation earnings that they will use to repay loans. A good many observers believe that *current* student earnings are up substantially over the last decade, although there is no sufficiently clear evidence that this is so, or for just which students. On the other hand, loan repayments will take a considerably larger share of their future earnings in post-graduation jobs, unless double-digit inflation returns. The current earnings picture may well have improved, but the future debt service picture has definitely deteriorated. There is no way to strike a balance between these positive and negative effects, but it would be reasonable to assume that the self-help burden of meeting a typical student's college expenses has increased.

To round out this review of changing burdens it would be necessary to look also at the burdens institutions and the public bear. In a separate report The Eureka Project has examined the changing role of student aid in institutional finances.* Rather clearly institutions, especially independent institutions, have found it necessary to increase their allocations to aid funds in a major way, and often at great cost to other educational priorities. The institutional burden has increased and so has the level of institutional sacrifice to achieve goals of greater equality of opportunity.

It is the changing burden borne by the public that is most ambiguous. The current burden of taxes, other than payroll taxes, has been reduced. But the future burden of public expenditures, including program commitments and service of an enormously larger federal debt, has obviously increased. This means that the present burden of that part of the public old enough to be parents of college students has decreased, and that the prospective burden of that part of the public of an age most likely to be students has increased. Perhaps that is argument enough for giving students somewhat more of the present benefit of the public burdens they will surely bear in the future.

**Maintaining Balances*, March, 1988.

Comparing Proposed Alternatives

Whether to shift burdens or to make them more manageable, four types of college financing proposal are being discussed widely:

- *Income-contingent loan plans* that would make the amount of repayments on student loans depend on the income of the borrower. Repayments would be greater when income is greater, smaller when smaller. In this way, the borrower would never have to face paying a large percentage of income.
- *Prepaid tuition plans* that would permit parents (and others) to pay for tuition expenses incurred in some future year at today's prices. The purchaser would forego an ordinary investment return on the amount paid, and instead would have the peace of mind of passing on to others the risk of future tuition increases.
- *Tax-free or tax-deferred savings plans* that would give parents (and others) a tax benefit as an incentive to save for college expenses. In a tax-free plan there would be no income tax payable if accumulated principal and interest is ultimately used for education. In a tax-deferred plan, tax would be payable only at time of withdrawal, as with IRAs.
- *Public service plans* that would create opportunities for students to work in public service jobs and thereby accumulate credits against educational expenses.

Some generic comparisons among these plans can be made. One obvious question about these plans, in light of the discussion in the preceding sections, is how they apportion financial burdens, and what they would do about making those burdens more manageable. The four types of proposal are highly dissimilar in mechanism, but they can be seen as occupying niches in a taxonomy of sources of educational finance. What government and philanthropy cannot be expected to pay, then either families or students will have to pay. Each of these two parties can, in principle, pay out of savings, current income or borrowings. Thus, we can have a simple diagram in which the widely discussed proposals can be placed generically, as in Chart 2:

CHART 2
Current Proposals and the Sources of Finance

	Parents Pay	Students Pay
Out of savings	Prepaid Tuition; Tax benefited Savings Accounts or Bonds	Public Service Employment*
Out of current income	(A)	Public Service Employment*
Out of borrowings	(B)	Income Con- tingent Repayment Plans; Public Service Em- ployment*

*The correct cell depends on whether service precedes, is concurrent with, or follows the receipt of cash benefits.

A diagram like this one invites attention to its empty cells, and so it should. There is a good reason for the emptiness of cell A: Parents are finding it difficult to meet expected contributions out of current income—that is one of the main reasons for seeking new financing mechanisms. But there seems no good reason for the emptiness of cell B and the lack of much current discussion of making loans to parents more manageable. The PLUS program (CLAS in California) seems to be growing now, but its history of unpopularity with parents should make changes in the program a priority item in any consideration of alternatives to student loans. There should be ways in which parents' borrowing to finance the education of their children could be made more manageable. Independent institutions have devised parent loan plans of much ingenuity for their own students, but sensitive plans for parents in general have been lacking. There might, for example, be practical ways to guarantee that parent loans would be paid off when parents retire.

Managing Burdens Through Managing Risk

Income contingent loan and prepaid tuition plans have an important common feature: they deal with problems of risk. In the case of income contingent loans, the risk is that the student will at times

have earnings too low to pay off loans comfortably in equal installments. If relieved of this risk, the student would be willing, other things being equal, to borrow larger amounts.

In the case of prepaid tuition plans, the risk is that the costs of sending a student to college will increase in the future by an amount not fully offset by increases in family resources. To be relieved of this risk, parents are expected to be willing to save more, the savings taking the form of prepaid tuition.

When risk is shifted, it can be (a) shifted to someone else (through purchasing their willingness to take the risk, that is, "hedging"), (b) shared through insurance (that is, mutualized), (c) exchanged for other risks, or (d) spread over time. Accordingly, Chart 3 shows the risk related features of income contingent loans and pre-paid tuition plans:

CHART 3
Financing Proposals and the Management of Risk

	Income Contingent Loans	Pre-paid Tuition
Risk mutualized	Pooled repayment plans	(A)
Risk transferred by hedging contract	Low-income "insurance" under contract with guaranteeing agency	Yield on investment adjusted to pay for hedge
Risk exchanged for other risks	The risk of low debt service capacity exchanged for the risk of large liability if income is high	Plans with less than complete portability, refundability, or guaranteed yield
Risk shifted in time, but not to other parties	Loans with an income contingent repayment schedule, but no reduction of liability.	(B)

Again, empty cells invite attention. One can imagine how they might be filled: For cell (A) there could be plans protecting students and their parents from the risk that conditions not of their own making would deprive them of benefits under a prepaid tuition plan. For cell (B) one can imagine a prepaid tuition plan which, if it turned out to be inadequate, entitled the saver to take out a loan for the deficiency.

Incentives for Financial Planning to Manage Burdens

Enabling parents and students to manage risk is an expression of a larger purpose behind most of the proposed innovations. That purpose is to provide incentives for financial planning and for a commitment to follow through on such planning.

Savings bonds or educational IRAs that are tax free or tax deferred if ultimately used to pay for college expenses would do this simply and directly. The major mechanical difference between bonds and IRAs is that in bond programs eligibility for tax benefits is conditional on investing in specified kinds of state or federal obligations, whereas an educational IRA involves depositing funds in a monitored account whose funds are *then* invested in assets, often privately issued securities with higher yields. More important in terms of benefits is the difference between tax free and tax deferred treatments: in a tax deferred plan all income is allowed to compound, and not only after-tax income, but it is fully taxed when funds are

ultimately withdrawn. A tax free plan permits even ultimate withdrawal without recognition of taxable income.

The tax benefits of both kinds of program provide a clear incentive for saving. Variable interest rates can, at the same time, provide major protection against the risk of inflation without need to mutualize or shift that risk, other than to financial intermediaries. By making the consequences of saving and borrowing more predictable, such plans could make people feel more adequate to assuming financial responsibility, and they would give credibility to an effort to be rational in addressing long term goals. They provide a context in which the considerable pain of providing money for college in installments over many years can be more meaningfully weighed against the traumatic pain of providing it out of current income over a few years. It is perhaps useful to offer Chart 4 to summarize the variety of incentives for financial planning implicit in the proposals for new financing mechanisms:

CHART 4
Incentives for Financial Planning in Current and Proposed College Financing Mechanisms

	Tax Benefit Incentives	Subsidization by Other Plan Participants	Other Subsidy Incentives	Non-subsidy Incentives to Planning
<i>Parent Oriented Plans</i>				
Education Savings Accounts and Bonds	Zero or deferred tax on income	None	None	Assures growth of educational savings
Prepaid Tuition	Zero or de- ferred tax on appreciation (uncertain)	Often	Taxpayer or in- stitution absorp- tion of risk. Tuition discounts in some cases.	Predictability of costs
Life, disability insurance	Deferred tax in some cases	To the extent of mutualization of risk	None, unless fi- nanced as fringe benefit	Predictability of resources
Home equity loan	Mortgage interest deduction	None	None	Brings equity nest egg into planning for college
<i>Student Oriented Plans</i>				
Income-contingent loan plans	None	To the extent of mutualization of risk	None inherent to plans, but some would qualify for GSL subsidies	Assures feasibility of repayment
Graduated repayment plans	None	None	None inherent to plans, but some would qualify for GSL subsidies	Repayment sched- ule comfortable for typical borrowers
Public Service Plans	None	None	Accrued, current or deferred job subsidies	Offers an educa- tion-with-services package

The Importance of Details

Although the types of plan surveyed up to this point are clear enough in their leading ideas, and allow generic comparisons, details of a particular plan can be crucial to whether it would work, who would benefit from it and whether it would plausibly be good public policy for state and federal governments to underwrite it. Without analyzing individual plans, existing or proposed, some of the areas where details are important can be indicated.

Income Contingent Loans

An income contingent loan plan, most broadly defined, is one in which the amount of a borrower's repayment installment depends on the amount of his or her income for a corresponding period. The rationale for such plans is that higher education represents an investment that ordinarily yields a return in higher earnings. This fact would make it possible for higher education to be self-financing in the way that purchasing a piece of manufacturing machinery can "pay for itself," except for three facts:

- (1) An education is not an asset that lends itself to use as collateral for a loan to finance its purchase.
- (2) There are risks that an education may not, in fact, turn out to be productive of income, and these risks are hard for lenders or borrowers to protect themselves against.
- (3) Depreciation of the investment is not calculable.

The idea of income contingent loan plans is to have government or a private party take the risks that result from these facts and arrange for student loans on which the repayment obligations of borrowers vary with their incomes. If repayment obligations are set at levels which will pay off the loans of all borrowers in a pool, then high earners will end up paying off part of the debt of low earners, and in this sense the risks will be mutualized.

Great sensitivity to details arises if genuine mutualization of risk is to occur. As long as repayment burdens are not shifted to other borrowers, but merely stretched out, so that the borrower pays back the total debt with interest, and only the size of individual repayment installments is based on income, then the only important problem that is likely to occur is choosing the right way to set the interest rate for each

period. Obviously, an advantageous interest rate benefits most those borrowers who have outstanding balances the longest. A disadvantageous interest rate penalizes the same group. Of course, the party that sponsors the plan loses or gains *vis-à-vis* long and short period borrowers as these groups respectively gain or lose. But an effort can be made to devise a formula or a rate pegging method that will be as neutral as possible among all classes of borrower and the providers of loan capital.

Mutualization makes matters much more complicated because it means that borrowers contract to assume some part of the liability for repaying loans that have benefited others. The amount of this obligation must correspond to an income level, and the distribution of borrowers among income levels must be projected into the remote future on the basis of the earnings profiles of different occupations, expected overall income growth in the economy, and anticipated rates of inflation. To the extent that these matters are left open—e.g. by indexing to actual future inflation rates—then the borrower cannot know what he or she is committed to and obligations are only relatively predictable. The borrower can predict only that if he or she ends up in a higher income bracket, the repayment burden will be higher than those of borrowers in lower brackets. This is to an important extent self-defeating, since reducing risk is the motive students would have for participating in such a plan.

If, on the other hand, such matters as income profiles, economic growth and inflation are *not* left open, but fixed in line with the best current projections, in order to enhance predictability, then very small errors can have enormous consequences. Individual borrowers can turn out to be much bigger gainers or losers than anyone anticipated, and so may whole classes of borrowers. The sponsor may correspondingly end up losing or making large amounts of money, even if the plan was designed simply to break even.

There is the further complication that winners or losers may predominate among the graduates of a particular institution, class of institutions or institutions in a particular region. If so, the plan can look grossly unfair even though it was scrupulously designed with fairness a paramount consideration.

These problems are compounded by the phenomenon known as adverse selection. Those borrowers who see themselves as likely to pay more for protection against a risk of low incomes they believe to be slight will be disinclined to be participants in

a voluntary plan with mutualization features. Voluntary participants will therefore number among them a disproportionate share of borrowers who see themselves as having poor income prospects. Assuming that borrowers are more often right than wrong about their future earnings, adverse selection will increase the premium costs of those who *do* participate. It might also tend to concentrate winners and losers in particular institutions and classes of institutions even more than they otherwise would be. Although a voluntary plan offers the fairness of freedom of choice, its results are likely to *look* even less fair than an involuntary plan—that is, one in which borrowers are required to commit themselves to the plan as a term of their borrowing contracts.

It is because of these problems that the alternative of insurance only against very low income was mentioned in chart 3. If benefits were so restricted, the premium cost could be held very low, possibly low enough to be more than compensated for by the reduction in interest rate attributable to the federal guarantee, in the case of a plan tied to the GSL program, anyway. In any case, the problems of adverse selection and apparent discrimination among borrowers attending different institutions would be minimized. Also, making participation a condition of borrowing would seem much less onerous and unfair if the premium were held low.

Prepaid Tuition

The important details of prepaid tuition plans can be divided into four groups. There are sensitive details concerning what the parents give up when buying rights under such a plan, details concerning what they get in return, details relevant to how the IRS will view what they get and details concerning the exchange of risks involved.

What parents give up under such a plan is, besides their freedom in disposing of their money otherwise, the amount of the purchase price that is not refundable, with reasonable interest, at a later point. To the extent that some or all of the value of their contracts or the value of a refund is contingent on future events the parents cannot fully control, they are taking risks with their money, and the burden of such risks has to be considered part of what they “pay.”

What the parents get in return, besides perhaps

subjective peace of mind, can be one or more of several different outcomes. First, since they are getting a guarantee of an inflation-proof tuition level, they are, in effect, buying a hedge against inflation as it may impact college costs. Second, to the extent that future increases in tuition result not from inflation but from additional real costs of education associated with improvement in quality, they are getting an educational bargain incorporating a gift from the sponsor of the scheme or from other participants who do not take full advantage of it and who do not get a full refund either. They are, under the usual plans, getting some right to a refund, although it may be inadequate or contingent.

It is obviously very difficult to weigh what purchasers give up against what they stand to gain under these plans. The imponderability of such plans can be compared with that in mutualizing income contingent loan plans. For both, inflation is a major uncertainty. The international capital market, where billions are staked on the most astute projections of inflation, can change its mind over a few months or even days. The participant in a prepaid tuition plan, of course, gets protection against precisely this uncertainty, but gets it at a price, which may be too high or too low, just as a participant in a mutualizing income contingent loan plan may, because of inflation, commit too much or too little future income to obtain protection against low earnings.

Where income contingent loan plans and prepaid tuition plans differ is in the adequacy of data about participant behavior. Although many changes can occur affecting future income distribution among a group of college students, there is an enormous body of data on income distribution in the past to take into account. But there is little good data at all that would allow predictions of future choice of college for children still in elementary school, when many parents are expected to make their decisions about participation in prepaid tuition plans. Nor can anyone pretend to know how much of a bargain, because of quality improvement, prepayment will represent.

The tax system creates other uncertainties, and again, more for prepayment than for income contingent loan plans. For income contingent student loan plans the main uncertainties are the deductibility of interest (abolished, for now anyway) and the overall progressiveness of the tax system. (Progressivity represents a sort of low income insurance in itself, since a highly progressive system such as the

United States had a few years ago tends to make real after-tax incomes less unequal.)

For prepayment plans the matter of taxes is far more complicated. That is because these plans are being elaborated with an eye to the tax collector from the beginning. Some of these plans deliberately *create* risks for participants so that they will be more likely to obtain tax benefits, although the attractiveness of the plans to parents also depends importantly on their being a vehicle to *reduce* risk.

This apparent paradox comes about because the advantage parents gain from participation must not look too like income, or else it is likely to be taxable either to the parents or, sometimes as bad now, to the child. There are two approaches in this kind of second-guessing exercise. First, the entitlement the parents acquire can be made to look less like a financial asset, so that its enhanced value when the child goes to college will not look like an *appreciated* asset, for appreciation suggests taxability. This puts a premium on taking away from the parents' entitlement as many as possible of the attributes of a financial asset. It should not, therefore, be marketable, unambiguously appraisable, or fully refundable. In general, the terms of the "cashing in" of the contract should be uncertain. The second approach is to make any enhancement of the value of the contract look less like income *produced* by an asset. Any enhancement should, therefore, not be readily measurable in dollars, either at the time of use or earlier through refund provisions.

All of this second-guessing accounts for some very unattractive features of prepaid tuition plans. It all but excludes anything like the compound interest that would be received on a bank account or CD. Transferability of the right to other students or use of the right as a fixed dollar offset to tuition at a large number of different colleges and universities or premature refundability with interest tends to be avoided.

Much of the uncertainty about tax benefits must eventually be resolved by the IRS. The IRS is reported to have advised the state of Michigan informally that, under its particular plan, appreciation would be taxable to the child, not the parents. It is not clear how far this advice foreshadows a general rule or what its terms might be. There are three plausible outcomes:

- (1) The IRS may rule that all enhancement of value is income (to parents or child) according to a measure that can be applied with great

uniformity. In this case, there would be great pressure to eliminate many sources of uncertainty from the plans, at least those that were designed merely to protect tax benefits, since they would no longer do any good. The wish of parents to hedge against risk would therefore be more likely to prevail.

- (2) The IRS may rule that enhancement in value does not represent income when the entitlement is in fact used as an offset to tuition. Again, in this case, there would be no need to introduce contrived uncertainties into the plans, and there would be a natural pressure to eliminate them. Prepaid tuition plans that approximated tuition indexed IRAs, minus the deductibility of contributions and minus the penalty for early withdrawal, would then have great competitive advantages, and might sweep the field.
- (3) The IRS may rule that a plan receives tax benefits only if entitlements under it, or their enhancement, have certain characteristics which entail risks for the purchaser. In this case, we would be likely to see *both* plans with such risks, compensated for by tax benefits and quality improvement bonuses, *and also* plans without either such risks or bonuses. Both might be marketable.

College Savings Bonds and IRAs

Proposals to provide tax benefits as an incentive for saving toward college costs without indexing to changes in tuition levels are comparatively simple. Parents concerned about meeting college costs would start years in advance to put aside savings in a designated account or savings bond program. Accumulated savings plus interest would build a nest egg available to pay all or some of the college bills. Because the interest would not be taxed at all, or at least would be allowed to compound without an annual tax bite, the nest egg would grow faster and pay more of the bills.

The context of such incentives is important and should be recognized when subsidized savings plans are debated. On the one hand, parents commonly feel anxious about college expenses and believe that they should save in order to meet them. But too few do. It has been argued that consumerism, inflation

and low returns on savings accounts (before the era of deregulation) have together undermined the culture of thrift that was once a point of national pride. The role of tax benefits is to counter our tendency to spend rather than save, to make saving more habitual by making it more profitable. Tax subsidies would thus be buying a change in attitudes as well as an earmarking of family resources for education.

This kind of plan is not nearly as difficult to design as prepaid tuition, income contingent loans or public service employment. There *are* problems with savings plans, and these problems can produce strident debate. But such debate should not be allowed to divert attention from the great advantage in simplicity and intelligibility enjoyed by savings plans. Once tax benefits are clearly conferred by law, there are few unpredictable consequences, lurking but unknown dangers of unfairness, or serious risks that participants will get far less than they thought they had bargained for.

The main questions about education savings plans with tax benefits are two: (1) how much they would cost in lost tax revenues, and (2) just who would get the benefits of these losses. Concern about state and federal budgets and concern about channeling student aid money to students who need it most guarantee that these issues will be taken seriously, and so they should.

To a certain extent these issues can be dealt with head on. Eligibility for the tax benefits can be restricted to certain income brackets, or phased out over several brackets, as would some of the recent proposals. Benefits could also be made a function of college costs, so that parents of a student who chose a high cost independent college could receive benefits that parents in the same income bracket whose child chose a low cost college would not receive. Number of children and age of parents could also be factored into the formula, but such additional factors would pose a risk to the valuable simplicity of savings plans.

Channeling benefits according to need can also be achieved indirectly and approximately by limiting the subsidy to savings vehicles, such as U.S. savings bonds, that have a traditional place in the financial planning of relatively low income households. Tying the subsidy to other vehicles that lend themselves to check-off withholding at place of employment or to stipulation as a fringe benefit in collective bargaining agreements can serve the same purpose. Of course, it is not beyond the ingenuity

of higher income families to get themselves included in such arrangements, but such features do tend to assure that lower income families would participate significantly from the beginning.

Such targeting of benefits helps *both* to reduce total budget costs and to channel money where it is most likely to be needed. Further, to the extent that those families who participate are at or near income levels that would marginally qualify them for Guaranteed Student Loans or other aid, there would be a saving in interest subsidies or other aid funding, unless—as occasionally proposed—savings were to be ignored by the applicable need analysis system. If there is no such exemption, the saving in student aid accounts could be substantial—perhaps substantial enough, in the right budget climate, to permit grant increases for students from very low income families who would be unlikely to participate significantly in any savings program.

Any savings plan with tax benefits has a “middle income” bias, because middle and upper income families are those who can generally manage to save. But the bias could be far less than that of the ill-fated Middle Income Student Assistant Act (MISAA) which eliminated all criteria of need in the then heavily subsidized GSL program, for MISAA generated virtually no offsetting savings in need-based aid program accounts.

There is also a social insurance aspect of a targeted program that should be mentioned. If the final determination of tax free status is left (as it is in most of the plans) until the time the savings are actually used to pay college bills, then upper income taxpayers may well be inclined to participate even if their current incomes are too high to make them eligible for tax benefits, on the chance that their incomes may, ten or fifteen years hence, be low enough for them to qualify—perhaps because of retirement, perhaps because of bad luck.

Public Service Benefit Programs

Details are also important in proposals to offer student aid as a reward for public service, although the critical details are much less technical. Obviously, there are a number of permutations that can be explored:

- (1) Is all economically useful work to be recognized and encouraged, or only work of an

exclusively altruistic kind? Should the rewards, current and deferred, be greater, the same or less, than those of ordinary jobs students might obtain in the unsubsidized labor market? At issue are all the usual questions of who gets what jobs at what pay. Also at issue is whether public service jobs would add to the net earnings of all students and the aggregate financial contributions students make from employment.

- (2) Should public subsidies go solely into providing the aid awards envisioned, or should they also be used to subsidize the students' earnings and the operation of the programs in which they work?
- (3) Should the student perform the service obligation before receiving the aid and continuing with formal education (at the cost of postponing such education), or should the service be concurrent with education (limiting the hours and location of the work), or should the service be performed after completing some or all of the education (entailing that the motivating experiences would permeate the educational process less completely)?
- (4) Should only those who intend to go to college participate or should the plan include others and award them different benefits?
- (5) Should the program be for the young or for the old as well?
- (6) What degree of centralization is appropriate? Should administration be national, state, local or campus based? Should an attempt be made to set standards for eligible programs or should a wide range of quality be accepted?
- (7) How many public service jobs would be created? Would there be so many that enrollment levels would be affected?

Plainly, some of these permutations would create programs very difficult to administer, others much easier. There seems to be a cycle in discussion of public service plans: social needs are recognized and the ability of students to help meet them is recognized also. Then large-scale proposals are made. But the costs and administrative difficulties of the proposals are also recognized, and enthusiasm recedes until the cycle begins over again.

The way to escape this cycle may simply be not to attempt a national program at all, or even a program beyond the jurisdiction of the individual college. Each college could take the responsibility to put

together the social needs it sees and the talents of its students on a case-by-case basis. If the service students perform is also going to help them pay their college bills, some astute fund raising and contract negotiation will be called for, together with some way for the bursar's office to credit student accounts appropriately. But these challenges to campus ingenuity should not bring efforts to a halt, as the troublesome features of large scale plans frequently have.

Additional Alternatives

Earlier in this paper the use of charts suggested that other alternatives to existing financial mechanisms could be developed besides those currently in vogue. There are still other alternatives that should not be neglected in the current discussion:

- (1) *Cooperative education* programs in which the academic calendar is adapted to permit students to obtain apprentice-type jobs in industries they are seriously considering for their careers. The amounts students earn in such jobs often make a far larger contribution to college expenses than the ordinary kinds of student employment. A great deal of administrative ingenuity is required if a large fraction of an institution's student body is to participate in cooperative education. The difficulty of making arrangements and finding the jobs does not, however, appear to be the source of resistance to cooperative education. There seems also to be the feeling that classroom learning could be disrupted and that the vocationalism of today's students, already great, might be unduly reinforced. These could be genuine and serious problems.
- (2) *Raising student earnings expectations* would be reasonable for many students. However, while some students now seem able to earn much more than students of earlier generations, some cannot. A general increase in student earnings expectations would therefore seem to call for more discretionary funds in the hands of student aid administrators to even up the differences.
- (3) *Parental loans tied to the need analysis system* might have considerable merit. If the annual repayment burden was geared to a fraction of the contribution parents would be expected to

make on behalf of a student still in college, then a sense of fairness would be imparted to expecting parents to meet some educational expenses through additional borrowing. The program could be either along the lines of a mutualizing income-contingent loan program or those of an income-scheduled repayment program.

Appraising the Alternatives

What are we to make of all these alternatives? Even looking at them only in their generic forms, as we have done here, and disregarding their possible permutations and combinations, it is a long and varied list.

The question "Which alternative is best?" is much the easiest to deal with: It is the wrong question. The problem being addressed is that current financing mechanisms have brought about reliance on too few sources of finance. Parents, governments and students are regarded as subject to great strain as a result, and none of them seem willing or able to provide enough financing through existing mechanisms without increasing difficulty. It would, therefore, seem the height of folly to choose one of the proposed new mechanisms and neglect the rest, for this would be again to run the risk of over-reliance on a single mechanism.

Nor does it seem very wise to regard any of the new proposals as a vehicle for getting one of the parties to the financing of higher education "off the hook." The GSL program was, in effect, used by some parents to get "off the hook" in the 1970's and hardly anyone else liked the result. Since all of the proposals look to particular parties to increase their long-run contributions, selection of one of the new mechanisms to the exclusion of others would, in effect, bring about a shift of burdens from one party to another.

The outcome of current explorations that would seem most consistent with the strength and adequacy of the system of higher education finance would appear to be a state of affairs in which parents and students continued to make contributions from current income, governments continued their grant

programs, students still borrowed limited amounts under the GSL program or an improved successor, but in which, in addition, there were several alternatives to make financial burdens less risky and more convenient to bear.

Although, for the above reasons, it seems unwise to narrow the field of alternatives to a single solution, there is one important criterion that can help in comparing alternatives and their permutations across the entire range of proposals. It concerns the use made of subsidies. The main justification of subsidies—whether from government, philanthropy, colleges and universities or other students—is to provide incentives for one or another party to provide more financial resources. The idea would be that subsidies can provide considerable leverage, bringing forth more money than they cost. Certainly this may be so. But in this calculus of leverage, two things are not to be forgotten. One is that, for some parents and students, simply being able to manage their financial burdens in a less risky and inconvenient way would be quite enough. They could be well content with mechanisms requiring no subsidy at all. If, then, a program is created in which subsidies are offered, all of these parents and students will have to receive benefits for doing something they would do anyway. In their case, there is no leverage, and a transfer of resources is pointless.

Second, subsidy dollars are scarce, and there is a strong case for using them primarily to finance the scarcest form of student aid, namely grants. In an economy such as ours the amount of credit available to finance higher education has no pre-set limits. In such an economy, unsubsidized jobs for students, among others, are created every day, again without predetermined limits. But subsidies are the *only* way to have grants, and only grants can bridge the gap between what colleges costs and what low income families can afford to pay—even with the most sophisticated saving, loan and employment mechanisms. Accordingly, the case for public or philanthropic subsidy of any of the new mechanisms surveyed here should be asked to pass a severe test: the subsidy must bring forth enough additional financing from parents and students that grant funds for students from the lowest income families can actually be increased.

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